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Executive summary

Future directions for foreign banks in China
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This article highlights the challenges and opportunities that foreign banks face in China. Based on interviews with 38 foreign bank Chief Executive Officers (CEOs) and senior executives between July and September 2013 – a period when several significant initiatives were underway, which will have a direct impact on the course that different foreign banks will chart over the next three to five years, such as the ongoing internationalization of the Renminbi, interest rate liberalization, and the form and scope of the recently announced Shanghai Free Trade Zone – this article provides insights on the future directions the foreign banks may pursue. We find that foreign banks will seek to grow fee income and develop their advisory role outside of China. The latter change will be assisted by Chinese corporates as they expand internationally, through acquisitions and greenfield investments. Such developments will foster foreign bank relationships, both offshore and onshore. Foreign banks will continue to evolve and choose different paths of expansion, based on their strengths and market opportunities. While some are building a retail presence and expanding their networks, others will focus on narrow market niches. Some of the larger foreign banks have divested their holdings in the large commercial banks, but simultaneously have moved into the securities and trust businesses. As the financial reforms take shape, new opportunities will emerge through the synergies gained by these diversification strategies.
Future directions for foreign banks in China

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Abstract

This article highlights the challenges and opportunities that foreign banks face in China. Based on interviews with 38 foreign bank Chief Executive Officers (CEOs) and senior executives between July and September 2013 – a period when several significant initiatives were underway, which will have a direct impact on the course that different foreign banks will chart over the next three to five years, such as the ongoing internationalization of the Renminbi, interest rate liberalization, and the form and scope of the recently announced Shanghai Free Trade Zone – this article provides insights on the future directions the foreign banks may pursue. We find that foreign banks will seek to grow fee income and develop their advisory role outside of China. The latter change will be assisted by Chinese corporates as they expand internationally, through acquisitions and greenfield investments. Such developments will foster foreign bank relationships, both offshore and onshore. Foreign banks will continue to evolve and choose different paths of expansion, based on their strengths and market opportunities. While some are building a retail presence and expanding their networks, others will focus on narrow market niches. Some of the larger foreign banks have divested their holdings in the large commercial banks, but simultaneously have moved into the securities and trust businesses. As the financial reforms take shape, new opportunities will emerge through the synergies gained by these diversification strategies.
This paper examines the future directions the foreign banks may take in China. The findings are based on interviews with CEOs and senior bank executives of 38 foreign banking institutions in China. These interviews were taken at a time when there were significant expectations on the path to financial reform in mainland China. Several significant initiatives are underway that will have a direct impact on the course that different foreign banks will chart over the next three to five years, such as the ongoing internationalization of the Renminbi, interest rate liberalization, and the form and scope of the recently announced.

This article is organized as follows: In section 1, we look at the current situation facing foreign banks in China. In section 2, we look at the regulatory framework, followed by an analysis of how the Chinese market is opening up in section 3, and what the growth potential looks in section 4. In section 5, we look at product and segment developments and in section 6, we analyze how human resources have developed. Section 7 concludes the article.

1. Overview of the current situations

1.1 Foreign bank presence
As of the end of 2012, forty-two locally-incorporated foreign banks, 95 branches and 197 representative offices operated in China. Within this group of foreign banks, 37 locally-incorporated foreign banks and 25 branches were permitted to offer derivatives, 6 locally-incorporated foreign banks were authorized to issue RMB financial bonds, and 3 locally-incorporated banks were approved to issue proprietary credit cards. According to the China Banking Regulatory Commission (CBRC), foreign banks were present across 59 cities in 27 provinces.

Although these foreign banking institutions had experienced growth in the amount of assets they held, by 10.66% in 2012 to RMB2.3t (U.S.$376b), their market share based on total assets dropped to 1.82% in 2012. This level of market share was similar to that recorded eight years earlier in 2004. Deposits held by foreign banks increased by 7.74% to RMB1.43t (U.S.$234b) from 2011 to 2012 while loans totaled RMB1.04t (U.S.$17b), an increase of 6.4% from 2011 to 2012.

\[4\quad Source: CBRC Annual Report\]
As a group, the foreign banks generated after tax profits of RMB16.34b (U.S.$2.67b) for 2012.

CBRC has also reported the following ratios for the locally-incorporated foreign banks at the end of 2012: liquidity ratio - 68.77%, nonperforming Loans (NPL) ratio - 0.52%, capital adequacy ratio (CAR) - 19.74%, and core CAR - 19.25%.

Foreign banks continue to be overshadowed by the large Chinese commercial banks, the joint-stock banks, city commercial banks, policy banks and rural commercial banks (Figure 1). Despite the steady asset growth of foreign banks since 2008, they have failed to gain market share. Setting aside the large Chinese commercial banks, other groups, such as the city commercial banks and rural commercial banks have gained much stronger market positions than foreign banks.

Furthermore, the large domestic banks have started to expand their overseas presence. At the end of 2012, the CBRC reported that 16 Chinese banks had more than 1,000 overseas establishments in 40 countries. It is expected that this footprint will expand dramatically over the next five years as Chinese banks grow their international operations by establishing new subsidiaries and branches and through acquisitions.

A key question is, if the Chinese economy is now on the cusp of economic and financial reform, will the foreign banks be able to play a more important and diversified part in the Chinese financial services sector?
1.2 Some background statistics on the participants
The 38 banks interviewed employ 29,229 people and anticipate this number will expand to 35,274 by 2016, a 20.68% increase. However, three European banks anticipate that their number of employees will remain unchanged within the three-year period.

Some of these banks have an active retail banking presence, ranging from a customer base of less than 100,000 up to several hundreds of thousands. The number of multinational clients ranged from just 10 to 15, up to several hundred. For the state-owned enterprises (SOEs), most banks said they had relationships with between 20 and 35 SOEs while a few indicated up to 100. Only 10 banks were able to calculate the number of privately-owned enterprise (POE) clients, and this estimate ranged from 10 up to 800.

Twenty-three banks provided estimates of their cost to income ratio in 2013 and in 2016. This ranged from 90% to just 19% in 2013. All but three banks were above 75%. By 2016, none of these banks envisaged a cost to income ratio above 70%, although three banks were unable to provide forecasts.

Fourteen banks provided estimates on their loan to deposit ratios (LDR). Only one bank was above 75% while the lowest ratio was 40%. Three banks were unable to provide estimates for 2016. Four banks projected increases in their LDR by 2016.

The projected asset growth for the participants in 2013 was below that anticipated in 2016. Several participants attributed the slowdown to increased cost of funds and economic slowdown in 2013. Six banks anticipated no asset growth in 2013, while a further 10 banks expected growth of up to 10%. Thirteen banks anticipated an asset growth rate above 10%. Projecting forward to annual asset growth in 2016, one participant expects shrinkage, 10 banks fall below 10%, but 9 banks expect expansion above 20% with 2 banks expecting to double in size between 2015 and 2016.

The foreign banks' parent banks are strongly committed to their Chinese operations. Thirty-seven of the 38 banks stated that their parent's support was resolute. There was
only one dissenting bank, which stated that due to home country issues China was now a lower priority than in the past. Several participants said that the level of involvement between the Chinese operation and head office had increased. This is in part based on an expectation that the internationalization of the economy will present more opportunities for the foreign banks outside China and in particular, where those banks have a strong footprint, for example, a Spanish bank with strong representation in Latin America.

Twenty-four banks placed China in the “Top 3” most important target growth markets in the world. This group often includes countries such as India, Indonesia, Malaysia, Turkey, and parts of Africa and Latin America.

Going forward, the majority of foreign banks believed that their market share will stay the same nationally. Twenty-six banks believed it would remain static, while 9 banks forecasted an increase and 3 banks a decline. In contrast, 16 banks predict an increase in the secondary cities while 15 banks believe market share will remain the same. Seven banks predict a decline.

Therefore, despite cautious optimism expressed elsewhere in this report regarding new product offerings, market liberalization and internationalization, most foreign banks do not anticipate any significant change in market share based on total assets.

The foreign banks have a much larger market share in Shanghai and the creation of the Shanghai Free Trade Zone may allow further gains. However, market share based on total assets is probably not the best measure going forward.

The branch networks of the “Big Six” retail banks, Bank of East Asia, Citibank, DBS, Hang Seng Bank, HSBC and Standard Chartered Bank are concentrated on the eastern side of the country with a heavy emphasis on the Tier 1 cities of Guangzhou, Shanghai, Tianjin and Beijing.
1.3 The challenges facing the respondents in competing in the Chinese banking industry?

Participants were asked to score three different groups of challenges they faced in operating a foreign bank in China, namely regulatory, operational and market growth.

1.3.1 Regulatory challenges

The participants believe that they face a plethora of rules and regulations which expand in scope each year. One participant maintained that they are required to file 6,300 different reports annually, in contrast to their parent bank, which files 400 reports with its home regulator.

Foreign banks are frustrated with their access to the China bond market which, at around U.S.$4t, is the fourth largest in the world. Some of the larger foreign banks do have access to the market. Furthermore, the issuance of Renminbi Qualified Foreign Institutional Investors (RQFII) quota to foreign banks, allowing their clients to invest in Chinese bonds, may become an attractive new product offering for foreign banks.

The third most important regulatory challenge was capital and liquidity constraints. These issues are discussed elsewhere in the report. The capital issue has become more critical for foreign banks since the survey interviews took place.

In October 2013, CBRC proposed that the minimum registered capital for newly incorporated foreign banks should be raised from RMB300m to RMB1bn (U.S.$164bn). Registered capital is the amount required for a foreign bank to be granted a new bank license.

1.3.2 Operational challenges

The most important operational challenge facing foreign banks is attracting and retaining well-qualified and skilled personnel. Although staff turnover appears to be slowing, many foreign banks continue to feel vulnerable to competitors poaching key personnel.

The legal environment is also a significant operational challenge, followed by the related issue of governance in client companies. The foreign banks are also conscious of the pressure on future profitability.
1.3.3 Market growth challenges
The top three market growth challenges facing the foreign banks were margin compression, attracting and retaining profitable retail customers, and domestic bank competition.

Margin compression will, in the short term, affect the appetite of foreign banks to expand their loan books and impact profitability. The locally-incorporated foreign banks with a retail focus continue to expand, but domestic banks are pursuing the same target customer base with improving service. China Merchants Bank, for example, is acknowledged by the foreign banks as a formidable competitor in retail banking.

1.3.4 How would you rate the health of credit and risk in the corporate and retail markets?
Domestic banks: when asked to record an opinion on the wellbeing of both corporate and consumer credit in domestic banks, 78% of the respondents expressed concern that corporate credit was deteriorating. This was in part a reflection of the slower economic growth rate, interest rate liberalization, and recognition that the nonperforming loan (NPL) ratio in domestic banks is rising. This view did not extend to consumer credit, where 17 of the 22, who expressed an opinion on consumer credit, felt that it remained stable.

While 80% contended that operational risk for domestic banks remains the same, this is not the case for market risk, which just over 50% believed was worsening.

Foreign banks: a much more stable view is articulated by the foreign banks when they report on credit and risk assessment of their own operations in China. They recorded their highest value deteriorating score for market risk at 24%, but most believed there has been minimal change for corporate and consumer credit and operational risk.

2. The regulatory framework
To get a better understanding of the views of the foreign banks toward the regulatory environment, two important documents were reviewed. One published annually by AmCham China, which reflects the views of the American banks, and the second is published by the European Chamber of Commerce (E.U. Chamber) in China, which itemizes a list of regulations that are of concern to its members.
Table 1, which is based on issues raised by the E.U. Chamber and required each respondent to rate the headlines on a scale of 1 to 10, in terms of importance to their bank, demonstrates that the foreign debt quota is the most important regulatory issue for foreign banks.  

In early 2012, the long-term debt quota allocated to foreign banks was doubled to U.S.$24b, permitting more money to flow into China from the outside. While some foreign banks appeared to be content with their existing quotas, there were a number of participants who have not enjoyed increases and contended that the quotas hinder their ability to meet demand for loans and investments.

The second most important regulatory issue was the 75% loan-to-deposit ratio followed by the foreign guarantee quota and the desire to broaden the LDR by including other liquidity sources in the ratio, both coming third. Foreign banks contend that financing for foreign invested companies often requires a guarantee from a foreign bank or foreign parent company. These foreign guarantees are included in the foreign debt quota.

Other concerns, all scoring around 8 out of 10, were the 10% withholding tax, the 5% business tax, and the tax assessment on representative offices based on their costs. Interestingly, at the bottom of the list were the restrictions on branches and sub-branches. Foreign banks have often complained about the “one branch at a time” approval process. The positioning of this concern suggests that participants believe that the process is speeding up and becoming less burdensome. As foreign banks expand into secondary cities, their plans are experiencing a more ready approval by the regulators.

2.1 Critical regulatory issues for foreign banks
Thirty-seven participants answered this open-ended question, and responses revealed that the two most critical regulatory issues were the loan-to-deposit ratio and the net open position (NOP) rule. The LDR, which refers to the 75% ratio of loans to deposits, continues to pose major challenges for a number of foreign banks because of their limited branch
networks and ability to obtain deposits. The NOP rule, which was introduced by the State Administration of Foreign Exchange (SAFE) in May 2013, links a bank’s onshore foreign exchange LDR with its NOP floor. The rule requires that once a foreign bank’s foreign exchange LDR ratio exceeds 100% (75% for domestic banks), a new NOP floor will be set for the start of the next month.

Other regulatory matters that were of concern to the respondents include:

- **Liquidity**
- The “three measures and one guideline” - this regulation came into existence three years ago and covered a new set of risk management rules. Although most foreign banks have adjusted to these rules, several smaller participants noted that it continued to be onerous.
- **Branch network expansion** - the CBRC’s “one branch at a time” policy is viewed as tedious and limits growth. Foreign banks can not submit simultaneous branch applications. The relatively lower score given to this factor in the previous question may suggest that some banks (the larger ones) are no longer finding this difficult.
- **Foreign debt quota**
- **Capital inflow regulations**
- **Regulatory overlap and insufficient clarity** - this also included what some foreign banks believe are at times contradictory policies between the People’s Bank of China (PBOC) and SAFE, different interpretations between provinces and the need to sometimes deal with three to five regulators. One bank cited an example where National Development Reform Commission (NDRC) approved of their decision to bring CNH (offshore RMB) deposits on-shore while PBOC disapproved.
- **Basel III challenges**
- **Capital changes on derivatives**
- **RMB loan quota**
- **Employee initiated financial crime**
- **New regulations** - when new regulations are first announced, the guidance on implementation is often weak.
- **Regulation of wealth management products**
- **Brokerage, full access still restricted**
2.2 How will interest rate liberalization affect your bank in China?
The move to liberalize interest rates and make them market accountable has been viewed as a basic requirement in the rebalancing of the Chinese economy. To date, interest rate liberalization has been asymmetric with action on lending rates but no changes to deposit rates. The general consensus among participants was that margins will be squeezed in the short term as lending rates decline. This will lead to reduced bank profitability.

The foreign banks believe that if deposit rates are deregulated and a market rate-driven environment emerges, this will benefit them. These foreign banks feel that since they are better skilled at managing risk and adapting to change, such a move would allow them to better differentiate their products on both price and risk. They also felt that mid-sized domestic banks would be particularly hit by such a move.

While a number of foreign banks were uncertain about when deregulation of deposit rates would occur, quite a few believe that it will happen soon, perhaps during 2014. A couple of banks linked the timing of a deposit rate deregulation to the introduction of a national bank deposit insurance scheme.

Some participants offered a different interpretation. Given that the domestic banks can now determine their own lending rates, they may choose to lower rates and ease the burden on the SOEs and local government financing vehicles (LGFVs). This may benefit the large domestic banks and place them in a stronger market position relative to all the other types of banks in the marketplace.

2.2.1 The launch of the loan prime rate
In October 2013, interest rate liberalization took another step forward when the interbank funding center launched a new loan prime rate (LPR).³

³ This topic is discussed again below as it relates to the impact of margin compression on foreign bank performance.
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The funding center, which is under the control of the PBOC, will strike an LPR calculated on a weighted average of the costs to the best customers of the top nine banks (namely Industrial and Commercial Bank of China, China Construction Bank, Agricultural Bank of China, Bank of China, Bank of Communications, China Citic Bank, Shanghai Pudong Development Bank, Industrial Bank and China Merchants Bank). Commentators believe that the creation of the LPR means that the PBOC has transitioned away from benchmark rates toward the new bank or market “influenced” rates. The first LPR rate was 5.71%, below the PBOC benchmark rate of 6.0%.

2.2.2 Future liberalization of deposit rates
On the deposit front, it is argued that the Memorandum of Understanding signed between the PBOC and the U.S. Federal Deposit Insurance Corporation (FDIC) on 24 October 2013, also suggests that China’s desire to relax restrictions on deposit rates and implement a deposit insurance scheme is well underway. This will be further discussed in the following section.

2.3 Deposit insurance
The PBOC has indicated that it plans to introduce a deposit insurance scheme. In general, foreign banks are supportive of this initiative and see it as an integral part of interest rate liberalization and a further step toward a practice followed in other countries. The respondents noted that while it will add costs, the heaviest burden will probably be borne by the big domestic banks.

Foreign banks with a retail presence welcomed the move. One bank suggested that the insured amount would be around RMB 500,000 (U.S.$82,000). This is below the U.S. where the FDIC insures deposits up to $250,000. In Canada, it is C$100,000 and in countries such as Germany, France, Netherlands and Spain, it is €100,000.

A number of respondents suggested that margin compression will inevitably lead to a crisis for a number of mid-sized domestic banks; hence the launch of a deposit insurance system seems both timely and prudent. An article in the China Daily on 3 September 2013, quoted an interview with Shang Fulin, CBRC Chairman, published in Qiushi Journal, in which he
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said that: “risk control remained a monumental task given the slowing economy, rising bad assets, industrial overcapacity and shadow banking.”

Relaxation of deposit rates is seen as a critical step in financial reforms. Increased competition may lead to bank failures, and although the Chinese public implicitly believes that troubled banks are, and will continue to be, supported by the government, this may no longer be the case.

A number of respondents argued that a number of mid-sized banks will find it difficult to compete effectively when reforms take hold, and this may result in their acquisition by the larger banks.

The deposit insurance scheme could play an important role if such a scenario was to unfold. Clearly in the absence of such a scheme, the clean-up process could be much more challenging.

2.4 How far have the Chinese banks progressed on Basel III? What is its likely impact on the local banking market?

Foreign banks believe that Basel III will be a challenge to the big Chinese banks. The participants’ views varied on how much progress the domestic banks have made toward the implementation of Basel III. One view was that Basel III will require a higher capital ratio which will slow the growth of the domestic banks. An Asian bank suggested that it will reduce the level of available credit in the real economy. As a result, this may improve the competitiveness of the foreign banks.

A North American bank noted that the proposed steps toward financial reform will take place ahead of Basel III. Most participants agreed that the Chinese banks will require more capital. The Bank for International Settlements (BIS) published an assessment of China’s regulatory consistency with Basel III in September 2013. A summary of the BIS portrayal of the Chinese banking system is presented in Box 1.
The government’s cautious approach to the banking market has been demonstrated by its refusal to permit any new domestic entrants. The last one to gain approval was China Minsheng Bank in 1996. This bank ranked number 9 in China and 54 globally in the 2012 Banker rankings based on Tier 1 capital. The Banker records 96 domestic Chinese banks in its 2012 (Top 1,000 Global Banks.)

3. Opening up the market
3.1 RMB internationalization
The respondents indicated that the increased internationalization of the renminbi would provide a plethora of new opportunities for foreign banks across a range of areas. These will include trade settlement, offshore lending, offshore deposits, offshore and onshore investment products, and offshore raising of capital.

Industry experts have suggested that the path toward RMB internationalization will involve three steps:
- Step 1 for trade finance
- Step 2 for investment
- Step 3 – the emergence of the renminbi as a reserve currency

There has been significant progress made on the trade front, and as the financial reform process unfolds, developments will focus on investment flows. The foreign banks are optimistic that, as the market opens up, they will be able to provide increasingly innovative and sophisticated services, and leverage their international networks.

A number of foreign banks discussed the prospects of the development of RMB offshore centers in their home markets, such as Frankfurt, Hong Kong, London, New York, Paris, Singapore, Sydney, Taipei, Tokyo and Toronto.

The respondents believed that the scope of new opportunities will be based on the opening up of the capital account. Although they expressed uncertainty about the pace of financial reform and the ability of the new leadership to implement far reaching changes, early indications, such as the launch of the Shanghai Free Trade Zone and recent moves to facilitate the flow of capital into and out of China are positive developments. Nevertheless,
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Further developments regarding capital account liberalization, such as expansion of the corporate bond and derivatives market, will be needed. The respondents believe they can play a vital role in this process and hope that the process will gather momentum. As one participant commented, there is no reverse gear for RMB internationalization. One interesting observation made by a small foreign bank questioned whether the new opportunities associated with RMB liberalization will be restricted by the different regulators to the large global banks or whether all foreign banks will be able to share in the benefit.

3.2 The recently announced Shanghai Free Trade Zone

In September 2013, the government announced plans for the China (Shanghai) Pilot Free Trade Zone (FTZ). Initially, 11 financial institutions, including two foreign banks (DBS and Citibank), were given permission to register in the FTZ. At the time of writing this article, two additional foreign banks (HSBC and Bank of East Asia) have been added.

While the interviews were conducted prior to the official announcement, in anticipation of the FTZ’s creation, participants were asked if whether it would allow foreign banks to introduce new services and expand more rapidly. Despite the limited availability of information at that time, most respondents were optimistic about future opportunities. Three respondents did not think that foreign banks would benefit while a further nine banks remained neutral. However, five banks agreed it would foster expansion and a further five banks strongly agreed.

Foreign banks believe that the success of the FTZ will depend on the financial reform process and much rests on the speed of transition toward RMB convertibility. Several banks made reference to the often cited “Shanghai 2020” deadline. They believe that the reform process will need to be comprehensive and expedient if the goal of creating an international financial center is to be fulfilled by 2020. The general opinion can be summarized as cautious optimism. However, several banks believed that reforms would be made expeditiously and solid opportunities would emerge.
From the foreign banks’ perspective, a number of significant reforms are anticipated and these include:

- Opening-up of the financial sector with a relaxation of investment controls and innovation in trade supervision systems.
- Reforms that will advance RMB internationalization.
- Faster approval for foreign bank branch approval. Foreign banks located in the FTZ will no longer be required to operate as representative offices for two years before applying for branch status.

Further clarifications were provided in a CBRC notice on banking regulation in the FTZ. It noted that qualified foreign banks will be able to set up subsidiaries, branches specialized institutions, and Sino-foreign joint venture banks in the FTZ. It commented that sub-branches of foreign banks in the FTZ may be upgraded to branches and research will look at shortening the period it takes for representative offices to become branches, and for foreign banks to conduct RMB business.

The CBRC notice said that banking institutions in the FTZ will be supported to develop cross-border financing services including, but not limited to, commodity trade financing, supply chain trade financing, offshore shipping financing, modern service sector financial support, domestic loans under overseas guarantee, commercial paper, etc.

There will be support to undertake cross-border financial services including, but not limited to, cross-border M&A loans, project loans, overseas loans under domestic guarantee, cross-border asset management and wealth management, real estate trust, and investment funds, etc. It further suggested that a “green and fast access channel” for the banking sector will be established in the FTZ, aided by a time limit mechanism to improve access efficiency.

Of particular attraction to the foreign banks is the reference to “optimize the calculation methods and regulatory requirements for certain indicators such as the LDR and liquidity.”

Finally, a further interpretation document was issued by the Shanghai Municipal Government on 15 October 2013. The document posed the following question, “Has the
4. Performance and growth

When commenting on their own bank's financial performance over the next three years, 25 banks believe that it will increase slightly while seven banks optimistically believe it will improve significantly. At the opposite end of the scale, one participant predicted a significant decrease. A similar pattern was predicted for foreign banks as a whole. Twenty-one banks predicted a slight increase and four banks said they expected foreign banks as a group will see significant increases. Nine banks, however, believe the status-quo will remain and three forecast slight decreases (Figure 2).

These findings suggest the foreign banks expect to make steady, consistent progress toward improved profitability. However, the optimistic predictions elsewhere in this report surrounding regulatory reforms and the potential for improved growth are not matched by significantly improved profitability.

4.1 Corporate banking profitability

Figure 3 displays profitability (in terms of capital allocated) to nine different lines of corporate or wholesale banking. 31 banks provided responses to the corporate banking
question and 18 of them said that this line of business was profitable for them, while eight banks stated that it was very profitable.

In trade finance, 18 banks indicated being either marginally profitable or profitable, while 11 banks said this product line was very profitable.

4.2 Retail banking profitability estimates
Just seven banks answered this question. Success was mixed. Under the general heading of “retail banking” – lending, deposit-taking and transactional banking – three banks responded that they were profitable, two were marginally profitable, and two acknowledged that they were making losses.

Although several participants offer credit cards (either in their own name or as a joint card with a Chinese bank), only one responded and said they were marginally profitable. Foreign banks have acknowledged that they do not have the critical mass to make credit cards profitable. Personal loans have limited demand and one participant commented that the “Three measures, one guideline” regulation which requires the lender to identify a loan’s purpose and usage, makes this particularly challenging.

Secured lending, primarily in mortgages, was recorded as profitable by four banks. Only two banks commented on private banking, with one saying that it was profitable while the other said it was only marginally profitable. A number of foreign banks are active in this area but business is directed to, and handled by, their parent bank outside of China.

4.3 Expected return on equity (RoE) for 2014 and projected for three to five years
The participants provided predictions for RoE in 2014 and in three to five years’ time. While these are only rough estimates, they do provide insight into the foreign bankers’ assessment of the market’s potential.

Thirty-four banks offered opinions on RoE in 2014, and they were as follows: six banks expected an RoE of less than 10%, 10 banks between 10% to 12%, eight banks between 13% and 15%, six banks between 16% and 18%, and four banks between 19% and 21%. Within the same group of 34 banks, projecting forward three to five years,
two Asian banks, eight European banks, and five North American banks predicted an RoE of 16% or higher.

A similar question asked the respondents to comment on their Return on Assets (RoA) for 2014 and again in three to five years. Only 16 banks responded to this question and three of them suggested that this metric is not meaningful and was, therefore, not measured by their bank. Seven banks said that in three to five years, RoA would be between 0.8% and 1.1%, five banks between 1.1% and 1.4%, and three banks between 1.4% and 1.7%.

4.4 Future growth opportunities

*Figure 4* presents the views of the respondents on the growth potential of six different categories over the next three years. The banks believe that corporate lending, trade finance, small and medium enterprises (SME) and commercial lending, cash management and treasury, and corporate advisory services will all increase either slightly or significantly over this period.

Corporate advisory services are also expected to grow, with 10 banks expecting significant and 13 expecting moderate growth. These growth predictions are premised on the expectations that Chinese companies will continue to invest outside of the country.

The “other” category refers to cross-border transactions and consumer loans.

4.5 Revenue growth for individual participants

*Figure 5* presents the respondents’ estimates of projected revenue growth for 2013 and 2016. There are two noticeable positive outliers, with one bank expecting 100% growth in 2013 and in 2016, while another predicting 80% growth in 2013 and 100% in 2016. Otherwise, most banks clustered around the 10% to 25% growth mark for 2013 and 2016.

The one negative outlier expects 0% growth in 2013 and a contraction of as much as 8% by 2016.
4.6 Top areas for continued revenue growth
To provide further insights into their revenue projections, the respondents were asked to identify their top three revenue growth areas during the previous 12 months. It was assumed that these areas of growth would continue into the future.

The two most frequently cited areas of recent revenue growth were corporate lending and trade finance. Within the group of 38 banks, around 50% mentioned both of these product areas.

Other frequently mentioned sources of revenue were cash management and treasury, foreign exchange and FX derivatives, and for three banks, SME lending.4

4.7 Current and future levels of margin compression
When asked whether they had experienced margin compression, 89% of the respondents (33 banks) stated that they had indeed experienced interest rate margin compression in 2013, and that they also expect it to continue into 2014.

This will put pressure on profitability for all banks, both foreign and domestic. In response, the foreign banks will use three different strategies to alleviate the problem. They plan to increase fee income, rebalance their portfolios, and reprice their loan book (Figure 6).

Each option presents real challenges. They plan to increase fee income by providing more services to Chinese companies as they expand abroad. Many participants said rebalancing their loan portfolio would be very difficult and time-consuming. An Asian bank suggested that it was already transitioning to better quality credits and expanding transaction services. A North American bank said it was attempting to broaden client relationships and reduce its focus on lending.

4 In addition to the ones mentioned above, the following areas were also mentioned in no order of priority: acquisition activity (this area was often mentioned in the context of the markets where the banks have a strong presence, such as the U.S., Germany, Latin America and Russia), bond trading, equipment financing, energy financing, syndications, interest rate swaps, corporate deposits, expanding network in Western China, debt capital markets, transaction banking and mortgages and insurance.
In July 2013, the PBOC relaxed its control over lending rates by allowing lenders to price their loans based on prime rates. The LPR is based on the lending rates offered by nine commercial banks to their best corporate clients. The banks’ influence on the rate is weighted based on their market share of outstanding loans in the preceding quarter.

At the end of June 2013, the five largest domestic lenders represented 44% of the industry total. It is accepted that the new LPR is a better reflection of credit supply and demand. It will lead to a growth in swap products as corporations use derivatives to hedge interest rate exposure. This will represent increased opportunities for the foreign banks.

5. Product and segment developments

5.1 Products in demand
The respondents were provided with separate lists of different retail and corporate banking services, and were asked to rank the three services from each group that they believe will increase in importance for foreign banks by 2016.

5.1.1 Retail products
Twelve banks responded to questions about retail products and put investment products and mobile banking well ahead of private banking and credit cards (Figure 7).

5.1.2 Corporate products
Thirty-seven banks responded to the corporate services questions, and placed debt capital markets well ahead of securitization and interest rate swaps. Structured products, cross currency swaps, and online transaction systems followed (Figure 8).

The participants’ perspectives on the securitization market has been influenced by the PBOC’s announcement in October 2013 that locally incorporated foreign banks would be permitted to join a pilot plan that allows banks to package loans into tradable securities referred to as collateralized loan obligations (CLOs). The pilot scheme was previously limited to just domestic banks and was placed on hold during the global financial crisis. It is suggested that the scheme will be limited to relatively small deals in the U.S.$150m to U.S.$1.5b range.
5.1.3. Wealth management
Only 13 banks said they were targeting the wealth management segment. The respondents agreed that the products offered were generic and it was difficult to differentiate their offerings from those of domestic banks. Some mentioned serving Chinese clients with a link to their home market. One bank said that they provided low risk quality products, while another said that the market’s future potential was phenomenal. Several Asian banks mentioned that it was a challenge to compete with the large, long-established European banks. Another Asian bank said that their involvement in the wealth management market was being supported through a joint venture with a trust company.

It goes without saying that definitions of wealth management clients differ between banks.

5.1.4 Mutual funds
According to the Asset Management Association of China, the Chinese mutual fund industry totaled U.S.$650b (4% of deposits in the banking system) as of May 2013. Several foreign banks have been licensed by the China Securities Regulatory Commission (CSRC) to sell mutual funds, including HSBC, Citibank, JPMorgan Chase, Standard Chartered Bank, DBS, Hang Seng Bank, Bank of East Asia and Nanyang Commercial Bank.

Twelve banks shared their opinions on the difficulties of distributing mutual funds. Three quarters agreed that it would present challenges. However, it was considered a useful addition to the foreign banks’ product line. Some said they would offer just three to five fund company products, while others said they would offer a tailor-made fund advisory service.
5.1.5 Foreign banks’ interest in other parts of the financial sector

Foreign banks have also been active in recent years in forming joint ventures with securities companies, such as Deutsche Bank, Goldman Sachs, Morgan Stanley, Citigroup, JP Morgan and UBS.

Cinda Asset Management,⁵ for example, which has been given the go-ahead to list in Hong Kong, has two foreign bank shareholders, UBS and Standard Chartered Bank. Cinda is one of four asset management companies set up in 1999 to absorb problem assets held by China’s four largest banks.⁶

5.1.6 Foreign banks use of social media

The banks were asked to comment on their use of social media to promote foreign bank services. Five banks (all with retail operations) within a group of 33 respondents indicated that they use Sina Weibo. Sina Weibo is a micro-blogging site with similarities to both Twitter and Facebook. It is only active in the Mainland and some other Chinese-speaking markets, and had over 500 million registered accounts at the end of 2012. By June 2013, it reached 54 million active daily users. In January 2011, a rival service called Weixin or WeChat was launched by the Chinese internet company Tencent. WeChat already has over 100 million users outside of China.

Citibank has the largest number of followers. It uses Sina Weibo to promote credit card usage at Dining City in Shanghai, Beijing, and Guangzhou.

Both DahSing Bank and DBS feature investment products on their pages. DBS appears to target an internationally-oriented customer by promoting rates for both U.S. and Australian dollar deposits.

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⁵ Cinda Asset Management completed its IPO in December 2013.
⁶ The four asset management companies and the banks whose bad assets they manage are: Cinda (China Construction Bank), Great Wall (Agricultural Bank of China), Orient (Bank of China) and Huarong (Industrial and Commercial Bank of China).
Finally, Standard Chartered Bank highlights Priority Banking and its team of investment advisors. All of these examples and statistics were obtained from Sina Weibo pages and were not discussed separately in the survey interviews (Table 2).

5.1.7 Customer segments: future opportunities for growth

Figure 9 displays the levels of interest of the foreign banks in six different market segments: SOEs, POEs, SMEs, financial institutions, global corporates, and high networth individuals. Respondents were asked to score their level of interest in each segment on a scale of 1 to 10 where 10 represents maximum interest.

- **SOEs**: out of a total of 34 banks, 23 attributed an interest score of eight or higher in SOEs. Nine banks recorded the maximum score of 10.
- **POEs**: although POEs are a growing part of the Chinese economy, they are currently less attractive to the foreign bank than the SOEs – 15 attributed a score above eight.
- **SMEs**: the pattern of interest changes with SMEs. Only four participants assigned a score of 10, and overall only seven banks scored eight or higher. Ten banks out of a total of 23 banks showed minimal interest.
- **Financial institutions**: with the exception of just one bank, the foreign banks interact closely with other financial institutions in the Chinese market. 18 banks assigned a score of eight or higher in terms of their interest in this segment.
- **Global corporates**: 18 respondents scored eight or higher and 29 of the 35 respondents scored six or higher. As expected, global corporates that are active in China remain a key target segment.
- **High networth individuals**: only 19 banks responded to the importance of high net worth individuals. Just eight banks recorded a score of eight or higher, suggesting that this segment is of interest to just a small group of foreign banks.

5.2 Level of interest in investing in domestic banks and other parts of the financial sector

76% of the respondents believe that foreign bank interest in investing in Chinese banks has declined. One of the most frequently cited reasons for this change is Basel III, and the need to hold extra capital against minority stakes in other financial institutions.
Foreign banks that helped many of the larger Chinese banks go public have in recent years sold their stakes. For example, according to Dealogic, U.S. banks acquired a stake of at least U.S.$14.8b in Chinese banks between 2002 and 2010, and then sold U.S.$37.3b worth of these positions from 2009 to 2013.

Currently, foreign bank ownership is limited to 20%, and as one European banker noted, even if this was permitted to rise to 49%, foreign banks would still be limited in their management and control.

Some participants suggested that the pending process of financial liberalization may create instability among mid-sized city commercial banks. A subsequent period of consolidation might then provide new opportunities for foreign banks if the CBRC permit takeovers of troubled banks. In addition to investing in banks, participants were asked to suggest other areas of the financial sector that might offer future potential for foreign banks. The banks suggested the following: securities companies, trust companies, leasing companies, factoring companies, consumer finance companies, asset management companies, auto finance companies and life insurance companies.

6. Human resources developments

6.1 Levels of demand for different foreign bank positions

The respondents were provided with a list of 17 different job functions and asked to rank the top five in order of importance (Figure 10). At the top of the list was corporate relationship bankers, which was selected as the most important job function needed by 20 banks. The second position in highest demand was legal and compliance personnel, ranked by 26 banks. In third position was risk management personnel, ranked by 16 banks.

The numbers can be further refined to display the needs of particular types of foreign banks. For example, relationship bankers in retail banking were selected among the top three positions by six banks within a group of eight banks.
Future directions for foreign banks in China

Three banks ranked branch personnel in the Top 3. Staff functions that recorded very low levels of interest were accounting, finance, new product development and taxation.

6.2 Skill shortages

*Figure 11* presents the results of the respondents’ rankings of seven types of skills required in banking. This evaluation supplements the results presented in *Figure 10*. It also highlights some of the cultural challenges faced by the foreign banks.

As *Figure 11* shows, foreign bank employees are viewed on a relative basis to lack leadership skills and international experience. Six banks highlighted leadership and four banks highlighted international experience as very serious human resource issues.

At the opposite end of the scale, three factors were viewed as not of great concern (based on an average score of less than 3 for 38 banks). They were, in order of decreasing concern, product knowledge, team orientation and client relationships.

A number of participants noted that because of the limited products permitted in China, product knowledge was not a significant concern.

6.3 Salary increases expected

A number of banks observed that salaries may not grow as rapidly in 2013 as in the past. One banker said that they were “not as crazy” this year while another said they anticipate only a modest increase during 2013. The most common estimated increase was 8%, made by 10 banks (*Figures 12* and *13*).

When asked to comment on the foreign banks as a whole, 13 of the 32 respondents also opted for 8%.

There were nine banks that expected salary increases of more than 8%, including two European banks and one North American bank expecting increases of the magnitude of 15%, 18% and 20%, respectively. One of these banks commented that they had not received a salary increase for three years and this was a catch-up move.
Overall, 36 banks envisaged salary increases in 2013 and only two banks said they would remain unchanged. Participants confirmed that there had been no remuneration changes in 2013 in relation to cash bonuses, equity options and bonus deferrals.

A Hong Kong foreign bank said that they now abide by CBRC rules on cash bonuses and deferrals. Another Asian bank indicated that they had begun to structure packages around staff retention strategies.

6.4 Foreign bank versus domestic bank salaries
The bankers were asked to compare levels of salaries for foreign banks versus their domestic counterparts across three different levels: senior management, middle management and support staff.

As Figure 14 presents, the belief remains that foreign banks, as a rule, continue to offer higher salaries. However, this is only part of the remuneration package and when other components, such as housing and car allowances and performance bonuses are included, the domestic bankers’ package becomes more attractive.

One participant summarized the position by saying that the elite domestic bankers earn a lot more while the mid-level bankers are more or less the same.

6.5 Staff retention
The average turnover rate for the 38 respondents was 14.2% in 2012 and they anticipated that this would drop to 12.9% in 2013.

One bank mentioned that it had lost 40% of its staff in 2012, including many front office positions. Another small foreign bank said it lost 30% in 2012, while a bank that lost 20% advised that if you record more than 30% turnover, a call could be received from the CBRC.

Figure 15 shows that 18 banks predicted 15% or higher turnover in 2013 versus 19 banks in 2012.

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Future directions for foreign banks in China

However, a review of individual bank percentages shows that five banks expected higher turnover in 2013 versus 15 banks which anticipated a decline. This suggests that retention is improving and this may be a reflection of the overall economic situation.

7. Conclusion
The future of foreign banks in China will much depend on the scope and implementation of the financial reforms. Interest rate liberalization, RMB internationalization and the FTZ offer a real prospect for accelerating the breadth of opportunities for the foreign banks in China. The overall sense is that foreign banks will have an important role to play in the opening-up of markets and a rebalancing of the Chinese economy for the years to come.
Appendix

Future directions for foreign banks in China
Box 1 – BIS’ portrayal of the Chinese banking system

Swiss Re launched its High Performance with High Integrity initiative in 2013. At the end of 2012, 511 commercial banks were registered in China, with total bank assets (including off-balance sheet assets) amounting to RMB129t (approximately U.S.$20t), circa 240% of GDP. The financial system is dominated by the five largest commercial banks, which hold about 60% of total banking assets. One Chinese commercial bank – Bank of China – is classified as a global systemically important bank (G-SIB). The CBRC is in the process of developing a framework for domestic systemically important banks (D-SIBs).

Under the new Basel III standards, the weighted average total capital ratio of Chinese banks stood at 13% in 2012 while the Tier 1 ratio and the CET1 ratio were both 10%. The ratio of nonperforming loans (NPLs) of commercial banks over total loans amounted to 0.95% at the end of 2012.

The average provisioning ratio (the ratio of loan loss provisions to total loans) for commercial banks was 2.82% (the CBRC requires all banks to meet a minimum provisioning ratio of 2.5% by 2016); and the provisioning coverage ratio (ratio of loan loss provisions to NPLs was 296%.

While the Chinese banking system is growing rapidly, the core of its banking business remains traditional, concentrated on credit products and services. This is reflected in a high proportion of loans relative to total assets and a relatively high share of RWA for credit risk as percentage of total RWA. Bank credit has increased from RMB16t in 2003 to RMB67t in 2012, equivalent to more than 120% of GDP. Overseas assets and assets denominated in foreign currency are relatively small as the focus of Chinese banking, thus far, is primarily domestic.
Box 1 – BIS’ portrayal of the Chinese banking system continued

The CBRC has been cautious in allowing banks to engage in complex financial activities. Some examples include correlation trading (which has not been permitted so far), and a closely monitored opening into securitization products and complex OTC derivatives. Reflective of this is the relatively small proportion of trading in financial activities, with an average market risk RWA of less than 1% of total RWA. The securitization markets are small and at a pilot stage. At the end of 2012, the volume of outstanding asset-backed securities was less than RMB20b.

In recent years, a market for wealth management products (WMPs) has developed. These products offer retail customers an alternative to traditional bank deposits and have seen strong growth, in part due to the existing caps on bank deposit rates. Banks offer WMPs directly but also indirectly through trust companies. In spring 2013, the CBRC issued new regulations for banks with regard to the prudential treatment of WMPs.

The Assessment Team discussed the nature and structure of WMPs and the possible economic similarity to securitizations. According to the CBRC, there is no tranching of credit risk and banks do not provide liquidity facilities to WMPs, and therefore WMPs are not classified as securitizations. The CBRC applies the standard credit risk rules if the WMPs are held on a bank’s balance sheet. As a result, WMPs were not considered by the team when assessing the CBRC’s implementation of the securitization framework.

Source: Basel Committee on Banking Supervision, Regulatory Consistency Assessment Program, Assessment of Basel III Regulations – China, September 2013. A pdf copy of this report is available on the BIS website, www.bis.org
APPENDIX: Future directions for foreign banks in China

Figure 1: The growth in bank assets 2008 to 2012
Urban credit cooperatives, rural credit cooperatives, non-bank financial institutions, new-type rural financial institutions and the postal savings bank have been omitted.

Source: CBRC
APPENDIX: Future directions for foreign banks in China

Table 1: Scoring of high priority regulations for foreign banks
Participants scored each factor on a 1 to 10 scale where 10 is maximum importance

<table>
<thead>
<tr>
<th>Issues raised by the E.U. Chamber</th>
<th>Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>Remove foreign debt quota</td>
<td>8.5</td>
</tr>
<tr>
<td>Remove the 75% LDR</td>
<td>8.3</td>
</tr>
<tr>
<td>Remove foreign guarantee quota</td>
<td>8.2</td>
</tr>
<tr>
<td>Include other stable liquidity sources in the ratio</td>
<td>8.2</td>
</tr>
<tr>
<td>Coordination by regulators</td>
<td>8.1</td>
</tr>
<tr>
<td>Waive the 10% withholding tax on offshore funding</td>
<td>8.1</td>
</tr>
<tr>
<td>Waive the 5% business tax on onshore and offshore lending</td>
<td>8.0</td>
</tr>
<tr>
<td>Remove the cost based income taxation of rep office</td>
<td>7.9</td>
</tr>
<tr>
<td>Improve communication between regulators re-target and policies</td>
<td>7.7</td>
</tr>
<tr>
<td>Licence approval process</td>
<td>7.6</td>
</tr>
<tr>
<td>Remove the two times capital limitation in the CFETS interbank market (PBOC)</td>
<td>7.5</td>
</tr>
<tr>
<td>Access to bond underwriting market</td>
<td>7.3</td>
</tr>
<tr>
<td>Greater ownership and scope for foreign vs domestic</td>
<td>7.1</td>
</tr>
<tr>
<td>Easier branch/outlet expansion</td>
<td>6.8</td>
</tr>
</tbody>
</table>
APPENDIX: Future directions for foreign banks in China

Figure 2: Financial performance of foreign banks over the next three years to 2016

Based on responses from 37 banks
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Figure 3: Profitability of corporate and wholesale banking
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Figure 4: Future growth opportunities
Parentheses on vertical axis shows number of banks
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Figure 5: Revenue growth projections for 2013 and 2016

Based on responses from 31 banks
APPENDIX: Future directions for foreign banks in China

Figure 6: Responses to margin compression

- Increased fee income
- Rebalancing of portfolio
- Repricing of loans

Based on responses from 38 banks making more than one selection
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**Figure 7: Retail products future demand**
Product bubbles represent relative levels of predicted future interest
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**Figure 8: Corporate products future demand**
Product bubbles represent relative levels of predicted future interest
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Figure 9: Priority scores of foreign banks

SOE priority scores
Based on responses from 34 banks

POE priority scores
Based on responses from 31 banks

Local SME priority scores
Based on responses from 23 banks

Financial institutions priority scores
Based on responses from 34 banks

Global corporates priority scores
Based on responses from 35 banks

HNW individuals priority scores
Based on responses from 19 banks
APPENDIX: Future directions for foreign banks in China

Table 2: Foreign banks using Sina Weibo

<table>
<thead>
<tr>
<th>Bank</th>
<th>Followers</th>
<th>Weibo posts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Citibank</td>
<td>150,864</td>
<td>334</td>
</tr>
<tr>
<td>Dah Sing Bank</td>
<td>2,388</td>
<td>256</td>
</tr>
<tr>
<td>DBS</td>
<td>109,280</td>
<td>5,089</td>
</tr>
<tr>
<td>Standard Chartered</td>
<td>41,695</td>
<td>1,623</td>
</tr>
</tbody>
</table>

Source: Sina Weibo, 21 November 2013
APPENDIX: Future directions for foreign banks in China

Figure 10: Bank positions in greatest demand

Based on responses from 37 banks
APPENDIX: Future directions for foreign banks in China

Figure 11: Most important skill shortages

Difficulty score based on responses from 38 banks
Figure 12: Estimates of salary increases in 2013 by participants for their bank only

Based on responses from 37 banks
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Figure 13: Estimates of salary increases in 2013 by participants for the foreign banks as a whole

Based on the perception of 32 banks regarding the foreign bank sector as a whole
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**Figure 14: Salary levels of foreign versus domestic banks**

Based on 27 banks' responses for senior management and 23 banks for middle and support management.
APPENDIX: Future directions for foreign banks in China

Figure 15: Foreign bank staff turnover rates in 2013 and 2013

<table>
<thead>
<tr>
<th>Year</th>
<th>&lt; 5%</th>
<th>5% to 9%</th>
<th>10% to 14%</th>
<th>15% to 19%</th>
<th>20% to 29%</th>
<th>&gt; 30%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>4</td>
<td>8</td>
<td>7</td>
<td>9</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>2013</td>
<td>3</td>
<td>9</td>
<td>8</td>
<td>11</td>
<td>7</td>
<td></td>
</tr>
</tbody>
</table>

Number of banks are shown in each category
Based on 38 banks' turnover rates in 2012 and projected for 2013
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